

USAID INSIGHT

PENSIONS AND CAPITAL MARKETS: ENGINES FOR ECONOMIC DEVELOPMENT

An aging population not only affects families that must care for their elderly parents and grandparents, it is a burden on the entire economy. This year, pension expenditures in Ukraine reached 18% of Gross National Product, which makes it into one of the largest pension burdens in the world. Over the next 10-15 years costs in Ukraine are expected to soar. If unchecked, they will sap future productivity gains and soon will be tapping into critical budget expenditures for health, education and infrastructure.

Ukraine, like most countries, pays current pensioners with contributions from current workers (pay-as-you-go system). This works well when the number of workers exceeds the number of retirees. Currently, the contributions of 100 workers support 90 pensioners. By 2020, this ratio will change to 100 workers per 104 pensioners; and by 2050, 100 workers will be needed to support 140 pensioners.

If the average pension remains at half the average wage, as it is under the current benefit formula, in 25 years, workers will have to pay 70% of their wages to support pensioners; no workers in any country would agree to that.

A better solution is to have workers save additional money for their retirement in a separate mandatory accumulation system. In this system, each worker contributes a percentage of his/her wages to an accumulation account. The contributions are invested, the returns added to the account balance, and the entire new balance re-invested. At retirement,

the entire account balance becomes available as a supplemental to the pension received through pay-as-you-go system.

It all sounds simple, but it is not. Hard to believe but the biggest problem would be what to do with the large amount of money that would be generated. Even if limited to half the work force (those under age 45), contributions from 8 million workers would soon generate the largest single pool of capital in Ukraine.

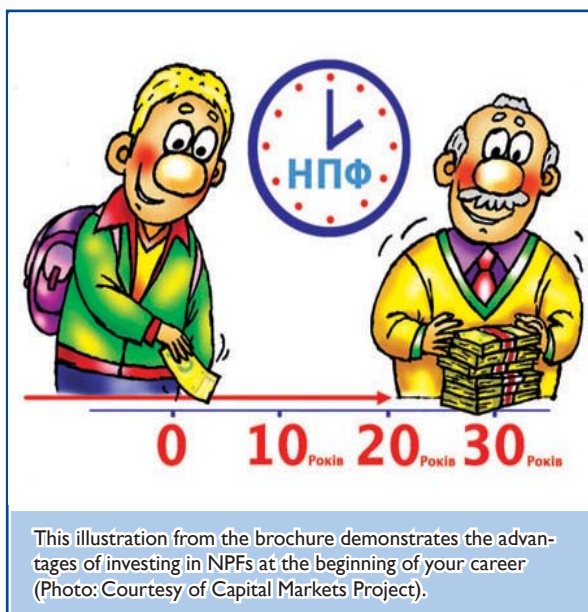
Five years after implementation, the new accounts would be generating \$4 billion per year. In a country with poorly organized capital markets, these precious savings could well be squandered. Just as critical would be the rate of inflation. Workers can only finance their own pensions if the contributions saved earn more than the rate of inflation. Otherwise, little is added to their nest egg for retirement.

The system would work if Ukrainian companies put the new pension savings to good use by supporting productivity and new jobs. That's what USAID's *Capital Markets Project* is about – turning workers' savings into secure investments in Ukrainian productivity and new job opportunities. In addition to dealing with Ukraine's pension system, the project also works on developing a capital market infrastructure; on developing stock exchanges, depositories for clearing and

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COMIC CHARACTERS PROMOTE UKRAINIAN PENSION REFORM

Comic characters from TV spot announcements and a brochure tell Ukrainians that they now have a great opportunity to develop an additional private pension.



Ukraine is a country with a quickly aging population and fast growing pension burdens. According to official statistics, Currently, the contributions of 100 workers support are 90 pensioners. The situation is expected to worsen in the coming decades. The only solution to this problem is to give Ukrainians the ability to hold both state and private pensions. In 2003, the Parliament of Ukraine passed a Pension Law that will implement a new three-pillar pension system. Informing people of the new great opportunity has become a top priority for the Government of Ukraine.

Though the Government has been promoting pension reform since 2004, Ukrainians are still inadequately informed about the Pillar III, which is the voluntary accumulation system, in particular on non-state pension

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Ukraine on Its Way to a Central Securities Depository

The idea of setting up a Central Securities Depository (CSD) in Ukraine is finally becoming a reality. All capital market players agree that the lack of such an entity is

one of the most crucial deficiencies of the local capital markets. Early this year, a consensus was reached among representatives of Ukraine's private sector, the Securities Commission, the National Bank of Ukraine and the international financial and donor community to establish a central depository through a merger of the All-Ukrainian Securities Depository and the Interregional Securities Union (MFS) Depository.

The independence and integrity of Ukraine's depository system is essential to the successful development of its securities market, supporting the investment requirements of the pension reform, and attracting of investment capital for production facilities and jobs. For more than 10 years, USAID through its various projects has been helping the securities industry develop the CSD by strengthening the MFS Depository and enhancing regulatory oversight by the Securities Commission.

Depositories play an important role in

securities trades. First, they ensure prompt payment for securities. Second, they speed up the movement of securities between buyers and sellers and minimize the chance of losing securities, playing a vital role in accurate and

the securities are registered to your broker on your behalf.

A central depository uses computers to keep track of all purchases and sales of securities that are stored in its vaults. It is a modern, fast and efficient way of handling all transactions. This computer-based data system records the holdings of all securities (government securities, equities and corporate bonds, etc) in electronic form. The CSD functions in the form of a "bank" for securities and it is linked to brokers that trade in securities, assuring their timely and expedient delivery and payment.

At the end of every trading day, transactions between firms are added up for every security. The depository sends a tab to each broker of the total amount owed by every other firm. Brokers then settle by sending funds to the depository for deposit in the accounts of other firms. Securities are transferred by book or computer entry. We can essentially say that a securities trade has been settled when a buyer has received the securities and a seller has received the money, and these transactions cannot be reversed.

A CSD is, perhaps, the most critical element in the securities market infrastructure.

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The independence and integrity of Ukraine's depository system is essential to the successful development of its securities market, supporting the investment requirements of pension reform and the attraction of investment capital for production facilities and jobs.

timely price discovery.

Today, you will find that most securities, especially shares, are locked up in the huge concrete and steel vaults of a depository. That means that you probably won't receive a certificate when you buy a stock unless you ask for it. You own it, of course, and your account records are your proof of ownership, but you'll never see it. Instead of being registered to you,

COMIC CHARACTERS INFORM UKRAINIANS ABOUT NPFs



This image from the brochure shows that it is possible to have both state pension and additional private pension benefits from an NPF (Photo: Courtesy of Capital Markets Project).

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funds (NPF) as a profitable tool to accumulate additional private pensions for retirement. To get the word out, an unconventional approach to the problem was needed, and USAID's Capital Market Project responded to this challenge.

To let working Ukrainians know that they could have an additional pension via NPF, the USAID Capital Markets Project (CMP) jointly with the State Commission for Regulation of Financial Services Markets of Ukraine (FSR) developed a public awareness campaign.

Two 30-second TV spots and a brochure were created. In the spots, comic characters show Ukrainians how money invested into NPFs work to augment their income. The sport and brochure demonstrate the two options currently available for Ukrainians when they retire: singular state pension payouts or, a state pension combined with private pension benefits from NPF. In addition, the brochure gives answers to frequently asked questions on NPF issues crafted on the basis of survey

results conducted prior to the awareness campaign.

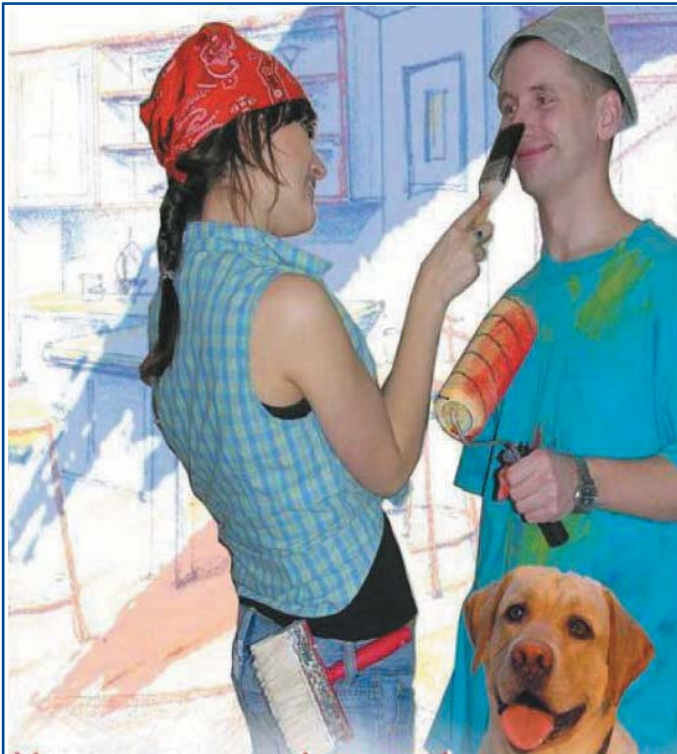
"These turned to be excellent information products. TV spot announcements became a trigger that made people ponder the NPF. When they saw the billboards advertising our fund, they decided to become our clients," says Iryna Okhrimenko, Nadiya NPF Board Chairman, Donetsk.

During July and August 2007, the spots were broadcast on 26 TV channels in 14 regions of Ukraine, and approximately 2 million viewers have seen them. Next week, the TV spots will be re-released to an association of pension fund administrators and to individual Non-State Pension Funds for national and regional TV airing. The association of administrators has been working with select members of the Rada to promote the TV spots on a wider range of TV channels. The brochure has been distributed to NPF administrators and attendees of all events on pension reform organized by CMP and FSR, including roundtables for employers on non-state pension funds issues conducted in six key regions of Ukraine.



Freeze-frame from the spot illustrates the tangible advantages of being an NPF participant. (Photo: Courtesy of Capital Markets Project).

Mortgage Credit: Simple, Cost-Effective and Available



An advertisement by one of Ukraine's banks states that it is "Time to Live Comfortably."

New mortgage launches by banks and a trained cadre of industry professionals will help Ukrainians buy new, comfortable houses and improve living conditions.

To be able to deliver services and satisfy the demands of their clients, mortgage lending officers at banks need to possess a variety of knowledge. Having applied to a bank participating in USAID's Certified Mortgage Lender (CML) Program, a potential borrower can count on first hand professional advice.

The Certified Mortgage Lender Program was launched in Ukraine in 2005 by USAID's Access To Credit Initiative Project in cooperation with the Institute of Urban Economics (Moscow) to address this demand. The major objective of the program is to support the development of a viable and effective mortgage lending sector in Ukraine by means of training mortgage lending personnel, and to bring mortgage lending in Ukraine closer to international standards and procedures. The CML Program had been used throughout the CIS and is based on a comprehensive study of methodological, economic and legal aspects of residential mortgage lending, including insurance and appraisal, pricing problems, evaluation and management of bank risks. Special attention is given to loan origination technology, borrower underwriting, and calculation of loan payments, and how the emerging mortgage systems in Russia, Kazakhstan and other transitional economies work.

A trained mortgage lending officer will make all the necessary calculations, consider available financial opportunities, help with relevant documents, choose the best property insurance rate, etc. Borrowers save time and receive answers to all their questions. To date, 98 recognized professionals representing more than 40 banks working in Ukraine are certified under the CML Program.

USAID Promotes Bonds in Ukraine

USAID promotes covered bonds to help home-buyers obtain loans

Covered bonds are a popular method among European banks seeking to refinance their portfolios to make it easier for home buyers to obtain loans. The buyer of such bonds – typically, insurance companies, pension funds, etc. – are protected because prepayments or slow payments or defaults are not passed-on by the issuer, but replaced with mortgages that have timely payments. Covered bonds are backed by a pool of high-quality mortgages that must meet a certain criteria, such as loans requiring large down payments. Banks like the covered bond concept because it helps them raise money for mortgage lending in markets that view mortgage-backed securities with suspicion.

In Ukraine, the first pilot covered bond was issued by *Ukrasbank* in 2007. The successful placement of a UAH 50 million bond in 2007 – prepared with extensive assistance from USAID's Access To Credit Initiative (ATCI) – signaled Ukraine's entry into the \$2 trillion European mortgage covered bond market. In 2008, inspired by *Ukrasbank's* success, another Ukrainian bank, *Khreshchatyk*, issued UAH 70 million bond, with a 'B+' Rating assigned by Fitch.

ATCI forecasts that by 2012, with the implementation of second pillar pension reform, covered bonds will constitute UAH 30 billion

of the domestic market.

GLOSSARY

Bond : A debt instrument issued for a period of more than one year with the purpose of raising capital by borrowing. Generally, a bond is a promise to repay the principal along with interest (coupons) on a specified date (maturity).

Covered Bond : A covered bond or note that is backed by mortgages or cash flows from other debt. If the bond issuer goes into bankruptcy, investors who purchased the bonds can lay claim to the underlying assets.

Municipal Bond: Bond issued by a city, or local government. Municipalities issue bonds to raise capital for their day-to-day activities and for specific projects that they might be undertaking (usually pertaining to development of local infrastructure such as roads, sewerage, hospitals etc).

Municipal Bonds Market Emerges in Ukraine

The Access To Credit Initiative has been providing assistance to Ukrainian cities to issue municipal bonds since late 2004. To date, four pilots have been issued – by the cities of Ivano-Frankivsk, Lviv, Berdyansk and Luhansk – in the amounts of UAH 5.5 million, UAH 92 million, UAH 10 million, and UAH

29.3 million respectively. The four pilots total more than \$28 million. The proceeds of the bonds are being used to repair roads and roofs for residential housing; improve street lighting; development and reconstruction of housing and municipal utilities, and for other municipal needs.

With these successful issues behind them, the cities of Luhansk and Lviv issued additional bonds for larger amounts – UAH 50 million and UAH 200 million respectively; and Ivano-Frankivsk is planning to issue its next bond for UAH 16 million.

ATCI expects to introduce even more cities to the advantages of municipal bonds as a source of capital through seminars to be held in conjunction with the Association of Ukrainian Cities later in 2008.



United States Agency for International Development's (USAID) assistance focuses on the following areas: **Economic Growth, Democracy and Governance, Health and Social Sector.**

Since 1992, USAID has provided \$1.6 billion worth of technical and humanitarian assistance to Ukraine to further the processes of democratic development, economic restructuring and social sector reform in the region.

For more information about USAID programs in Ukraine please visit the USAID website at: <http://ukraine.usaid.gov>

DISCLOSURE SYSTEM TO INCREASE TRANSPARENCY AND PROTECT INVESTORS IN UKRAINE

USAID is funding the establishment of a new electronic disclosure system, including a web-site (<http://eds.ssmc.gov.ua>) that provides a real-time access to the documents that public companies are required to file with the Ukrainian Securities and Stock Market State Commission (SSMSC).

What is disclosure? What is the relationship between disclosure and good investor protection? This quote perhaps summarizes it best: "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."

The quote belongs to Louis Brandeis, Supreme Court Justice of the United States. It was made in the context of the Great Depression and the turmoil in global financial markets of the early

1930s before President Roosevelt's reform programs led to the passing of the Securities Act of 1933, the Securities Exchange Act of 1934, and the creation of the U.S. Securities and Exchange Commission. During those years, financial transparency became the remedy of choice against the fraud and market manipulation that shook the financial markets of the U.S. and contributed to the global crisis of the 1930s.

Why is disclosure such a strong recurring theme? The answer is because it is an effective tool for improving investor protection. Without good disclosure, it is easy to take advantage of minority investors. Of course, with any disclosure regime some of the responsibility for protecting the investment is shifted to the investor himself. However, informed self-interest has proven to be quite effective.

The relevance of disclosure hasn't really changed since the 1930s. The mission of the Ukrainian Securities Commission in the early 21st century is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. As more and more Ukrainian first-time investors turn to the markets to help secure their futures with pensions, pay for homes, and send children to college, the government's investor protection mission is more compelling than ever.

The world of investing is fascinating and complex, and it can be very fruitful. But unlike the banking world, where deposits are guaranteed by the government, stocks, bonds and other securities can lose value. That's why investing is not a spectator sport. So the best way for investors to protect the money they put into the securities markets is to do research and ask questions.

The laws and rules that govern the securities industry in Ukraine today derive from a simple and straightforward concept:

The result of this modern electronic disclosure system is a far more active, efficient and transparent capital market that facilitates capital formation so important to Ukraine's economy.

all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and as long as they hold it. To achieve this, USAID's *Capital Markets Project* has helped the Ukrainian Securities Commission develop a system for public companies to

disclose meaningful financial and other information to the public. This provides a common pool of knowledge for all investors to judge for themselves whether to buy, sell, or hold a particular security. Only through the steady flow of timely, comprehensive and accurate information can people make sound investment decisions.

The result of this modern electronic disclosure system is a far more active, efficient and transparent capital market that facilitates capital formation so important to Ukraine's economy. To insure that this objective is always being met, USAID's project continually works with all major market participants, including pension investors in Ukraine's securities markets, to listen to their concerns and to learn from their experience in developing a world class electronic reporting database of disclosure documents.

With good information, the perception of risk in the markets is reduced, as is the cost of capital, and better management of enterprises is encouraged. Disclosure regimes do not appear to be designed for this purpose, but better markets and better disclosure seem to make for better companies. Better-run companies, in turn, contribute to greater economic efficiency and a greater capacity to generate wealth, which benefits the investor and all of society as well.

ENGINES FOR ECONOMY

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settling transactions, and regulatory oversight and legislation to protect investments. It also involves the more mundane, but equally important, job of educating workers on new pension and savings opportunities and helping today's pensioners who also need information and education.

Over its first three years, the project has assisted more than 3,500 pensioners a month through its Ministry of Labor and Social Policy hotline on pension reform issues. Four qualified pension specialists are always ready to answer questions on the new pension system's parameters. Each operator responds to approximately 80 calls a day from all over Ukraine. The hotline operates from 9:00 a.m. to 6:00 p.m., Monday through Friday. The **hotline number is 8-800-500-39-20** and calls are free-of-charge for residents of all regions of Ukraine.

Raising the awareness of potential pensioners is also a high priority. In 2003, a new law was enacted that created voluntary non-state pension funds to allow current workers and/or their employees to develop additional retirement funds. Although any Ukrainian can join, participation in such funds is still low (only 2% of those eligible). To raise awareness and explain the mechanisms of this retirement option, the project has developed two PSAs and a brochure on non-state pension funds issues (see *Comic Characters Promote Pension Reform*, p. 2 of this Insight issue).

The bottom line objective of the USAID project is to create vibrant and effective markets for stocks and corporate bonds. This will ensure that savings can go where they are most needed for investment when they are needed most. In turn, this will do more than increase productivity and create jobs. It will help sustain the economic growth essential for delivering pensions that are adequate, affordable and reliably financed.

Central Depository

CENTRAL DEPOSITORY, continued from p. 2

With strategic enterprises being privatized, and the advancement of pension reform placing increasing demand on Ukraine's securities market, the CSD should be capable of handling the ever-increasing flow of transactions while maintaining investor confidence in the safety of their investments. A proper functioning CSD will ensure the investor that accurate custody of ownership records is maintained, that shares will not be diluted, wrongfully lost, or challenged.

Apart from the obvious criteria that need to be met by the new CSD – such as independence, availability, reliability and international standards of efficiency – the creation of the CSD in Ukraine is, to a certain extent, a political issue and there is still a long way to go. However, the successful merger of the All-Ukrainian Securities Depository and the MFS Depository into a single central securities depository will be a major step for the development of Ukrainian capital markets and will bring Ukraine closer to international standards of depository, clearing and settlement operations.